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SUBJECT: SHADES OF GRAY: BULGARIA'S UNDERGROUND ECONOMY

1. (SBU) SUMMARY: Bulgaria's thriving underground economy is one of the few cloudy areas in an otherwise bright macroeconomic outlook. Most experts estimate the gray economy is responsible for 30-40 percent of GDP. Likewise 14 to 25 percent of the labor force are employed in the gray economy, suggesting Bulgaria's unemployment rate of 10.4 percent is actually lower. Bulgaria's underground economy has enabled those who are not benefiting from the booming legitimate economy to survive or even prosper. However, the gray market's existence has starved the state of significant revenues and acts as an impediment to economic growth. Reforms implemented ahead of Bulgaria's EU accession should improve the situation as more businesses are forced into the formal sector. END SUMMARY.

MAGNITUDE OF THE GRAY ECONOMY

2. (U) Despite Bulgaria's impressive macroeconomic stability and a record 5.6 percent GDP growth in 2004, the size of its shadow economy appears to be expanding. Experts estimate the gray economy produces between 30-40 percent of Bulgaria's GDP. While other observers believe this percentage to be much higher - up to 50 percent - most agree that the size of the gray economy has been increasing since its 1990 level of 26 percent.

THE NATURE OF THE GRAY ECONOMY

3. (U) A recent conference on the Hidden Economy and Transborder Crime in South Eastern Europe organized by the Center for the Study of Democracy (CSD) noted that the gray economy in Bulgaria includes activities such as the production of homemade foodstuffs (which are legal but not registered) as well as domestic and imported goods that are sold illegally, such as tobacco and alcoholic beverages. Additionally, informal professional services including doctors' or lawyers' services represent a key part of the shadow economy. The bulk of Bulgaria's gray economy activities, however, involve avoidance of import duties, such as the sale of Chinese manufactured consumer goods smuggled into the country. This trade in consumer goods is actually far more lucrative than the black market in, e.g., drugs. Another, highlighted to us recently by Deputy Finance Minister Kadiev, is the abuse of duty-free shops on Bulgaria's borders, which has served as a mechanism for avoiding customs duties and excise taxes on fuel, cigarettes and alcohol. Kadiev told us the Finance Minister foregoes some 400 million euros a year as a result of these duty-free shops, and lamented the fact that powerful political and economic interests have so far blocked efforts to close them.

4. (U) According to a study commissioned by CSD, companies considered to be part of the gray economy include those that evade taxes and fail to comply with business regulations. Tax evasion includes employment without contracts, underreporting of income for social security (pension and health insurance), and turnover suppression (not issuing receipts for VAT payment and income tax reporting). Larger companies tend to be more transparent in this regard, as they are better able to absorb the costs of paying taxes and complying with regulations. Gray sector business practices, particularly salary discrepancies, are most evident in Sofia and other large cities where firms can hide the practices more easily. Outright VAT fraud - as opposed to avoidance of payment -- is also a huge business, accounting for some USD 375-750 million a year in lost revenues, according to the government.

5. (U) Though Bulgarian tax rates are low compared to many countries in the region, they are a heavy burden for a workforce whose average wage is only 164 Euros per month. VAT and social security payments are also frequently avoided, according to the Institute for Market Economics (IME), particularly in the construction, agriculture, tourism, and wholesale and retail trade sectors. These companies maintain two sets of books: one containing financial transactions up to the minimum income required for VAT registration (25,566 Euro), and a hidden one for income over the minimum.

6. (U) Other businesses go "gray" due to noncompliance with licensing and registration requirements. Registering a new business in Bulgaria can require at least ten administrative

procedures. Many businesses comply with some regulations but not all, such as a tour company obtaining, but not renewing, an operating license. This is most apparent in tourism and subsistence-level businesses, such as family-owned grocery shops. According to the IME, weak enforcement of existing business regulations is also a problem, particularly in the labor market. In 2003 the GOB passed legislation requiring the registration of labor contracts. The level of unregistered work activity initially decreased, but the CSD found the level increased again after one year, suggesting the need for stronger enforcement of the new regulations.

CONSEQUENCES OF THE GRAY ECONOMY IN BULGARIA

17. (U) The gray sector reduces the overall efficiency of Bulgaria's economy and its ability to boost exports. Reduced revenue due to tax evasion results in fewer resources devoted to developing Bulgaria's infrastructure and public services. Informal businesses have limited access to capital, thereby restricting their potential to invest in new technologies and to compete effectively on external markets. Experts claim that for a small and open economy like Bulgaria, which should pursue an export-oriented policy, the existence of such a high level of gray-market activity is one of the key impediments to growth.

18. (U) An additional result of the gray economy is the underreporting of the number of employed people. About 14 to 25 percent of working-age people in Bulgaria are estimated to participate in the gray economy, which suggests that the unemployment rate--10.4 percent in October--is actually lower than reported. Given the widespread practice of salary discrepancies in labor contracts, incomes in Bulgaria are likely higher than what is officially reported, as the minimum wage is supplemented by amounts agreed to in "secret clauses."

COMMENT

19. (U) Foreign investment has begun entering sectors once dominated by the gray economy. This has already occurred in the retail sector following the establishment of major European chains. Yet Bulgaria's sizeable gray economy remains a significant barrier for international businesses, particularly small and medium enterprises, due to unfair competitive advantages held by local informal businesses. Larger investors are most likely to overcome this obstacle, using their substantial resources to cut through administrative barriers and negotiate favorable terms of trade. But as more multi-national firms enter Bulgaria, pressure will build to eliminate the gray economy's competitive advantage. Many working in the gray economy may be unable to make the transition and could bring new unemployment problems.

LEVINE